

Message Text

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R 171717Z JUN 75

FM AMEMBASSY LONDON

TO SECSTATE WASHDC 2050

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FOR TREASURY FROM JIM AMMERMAN

E.O. 11652: N/A

TAGS: EFIN. UK

SUBJECT: MEDIUM TERM OUTLOOK

REF: TREASURY REQUEST IN STATE 136051

SUMMARY: THE OUTLOOK IS FOR NO MEANINGFUL ECONOMIC GROWTH IN 1975, SOME SLOW UPTURN IN ECONOMIC GROWTH IN 1976. WITH STRONGER PERFORMANCE IN 1977 BASED ON EXPORT-LED GROWTH RESULTING FROM EARLIER UPTURN ELSEWHERE. THE U.K. IS LAGGING IN THIS CYCLE: THE SLUMP AND HIGH INFLATION WILL CONTINUE HERE LONGER THAN IN OTHER MAJOR COUNTRIES, UNEMPLOYMENT WILL CONTINUE TO RISE, AND RECOVERY WILL COME LATER. FURTHER RESTRICTIVE MEASURES ARE LIKELY TO BE TAKEN IN 1975 AND 1976 DESPITE INCREASING UNEMPLOYMENT. CAPACITY CONSTRAINTS COULD APPEAR IN 1977. END SUMMARY

1. MAJOR PROBLEMS IMMEDIATELY FACING U.K. ARE WAGE GENERATED INFLATION, SLOW GROWTH AND RISING UNEMPLOYMENT, LOW BUSINESS CONFIDENCE, ALL LEADING TO POOR INVESTMENT

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OUTLOOK. CURRENT LARGE PUBLIC SECTOR BORROWING REQUIRE-

MENT IS LIKELY TO ADD TO INFLATIONARY PRESSURE THIS YEAR AND NEXT. COMBINATION OF HIGHER EXPORT PRICES AND ECONOMIC SLOWDOWN ARE GIVING SOME HELP TO BALANCE OF PAYMENTS THROUGH IMPROVED TERMS OF TRADE AND DECLINE IN IMPORT VOLUME, BUT UNDERLYING DOMESTIC ECONOMIC AND SOCIAL PROBLEMS ARE SUCH THAT ANY PRUDENT FORECAST MUST EXPECT STERLING'S TRADE-WEIGHTED EXCHANGE RATE TO CONTINUE TO DECLINE BY A FURTHER 6 TO 10 PERCENT DURING THE NEXT TWELVE MONTHS, SAY 1.5 TO 2.5 PERCENT A QUARTER. BELIEVE OUTLOOK IS FAIRLY CLEAR FOR 1975 AND 1976, BASED ON EXISTING TRENDS, MUCH LESS CERTAIN FOR 1977 BECAUSE BY THEN DEVELOPMENTS WILL DEPEND (A) ON WHETHER FURTHER MEASURES TO BE TAKEN HERE TO RESTRAIN WAGE INCREASES AND CUT PUBLIC EXPENDITURE WILL BE EFFECTIVE AND (B) STRENGTH AND TIMING OF UPTURN IN WORLD TRADE AND ABILITY OF U.K. TO SHIFT RESOURCES INTO EXPORTS, WHICH INCLUDES QUESTION OF SUFFICIENT FUTURE INDUSTRIAL CAPACITY TO MEET EXPORT DEMAND WHEN INVESTMENT IN MANUFACTURING CURRENTLY EXPECTED TO FALL 15 PERCENT THIS YEAR FROM LAST YEAR AND REMAIN LEVEL IN 1976. SOMEWHERE IN THIS EQUATION MUST BE ADDED THE EFFECT OF LABOR PARTY LEFT-WING VISIONS OF STATE-DIRECTED SOCIALIST UTOPIA AND, MORE GENERALLY, NOXIOUS EFFECTS OF TAXATION AND INFLATION ON BUSINESS ENTREPRENEURIAL AND MIDDLE CLASSES.

2. REMAINDER OF THIS MESSAGE WILL GIVE MY JUDGMENT ON POINTS IN REFTEL, LARGELY FOLLOWING QUESTIONS IN PARA 2-4 OF REFTEL. THE OUTLOOK THIS YEAR IS NO GROWTH, PERHAPS SLIGHT DECLINE OVER THE FOURTH QUARTER OF 1974. YEAR ON YEAR FIGURES WILL SHOW SOME IMPROVEMENT, PERHAPS 0.5 TO 1.0 PERCENT GROWTH, BUT BEAR IN MIND THIS IS DUE PRIMARILY TO ABNORMALLY POOR FIRST QUARTER 1974 FIGURES WITH THREE-DAY WEEK AND MINERS STRIKE. RETAIL PRICE INDEX WILL INCREASE 25 - 30 PERCENT THIS YEAR. WITH UNEMPLOYMENT RISING TO OVER 1 MILLION BY YEAR-END, TO ABOUT 4.4 PERCENT.

3. I BELIEVE THERE WILL BE POLICY CHANGES DURING THE SUMMER AIMED AT CUTTING PUBLIC EXPENDITURE THIS YEAR RATHER THAN NEXT, AND WORKING TOWARDS A MORE EFFECTIVE LIMITED OFFICIAL USE

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INCOMES POLICY TO HOLD DOWN WAGE-GENERATED INFLATION. RECALL THAT IN FEBRUARY 1974, HEATH FOUGHT AN ELECTION ON QUESTION OF WHO GOVERNS BRITAIN. SINCE THEN, THE ANSWER HAS BEEN CLEAR: THE UNIONS DO. WHILE THIS IS AN EXAGGERATION, TO DATE THE LABOR PARTY HAS BEEN UNWILLING TO TAKE ON TUC IN ANY MAJOR BATTLE. IT MAY DO SO NOW THAT EC REFERENDUM IS OUT OF THE WAY, AND WITH UNEMPLOYMENT RISING, MODERATES IN UNIONS MAY BE ABLE TO

EXERT MORE INFLUENCE IN AN ATTEMPT TO BRING ABOUT VOLUNTARY RESTRAINT. THE GOVERNMENT CLEARLY INTENDS TO DO SOMETHING, AND THE POLITICAL CLIMATE IS FAVORABLE FOR ACTION. CHANCELLOR HEALEY SAID LAST WEEK THAT BUILDING SUPPORT FOR ACTION ON THE SCALE AND SEVERITY REQUIRED DOES TAKE SOME TIME, BUT THE GOVERNMENT IS DETERMINED TO

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REACH CONCLUSIONS IN THE COMING WEEKS WITH A VIEW TO HALVING THE RATE OF INFLATION WITHIN THE NEXT TWELVE MONTHS.

4. THE PROSPECTIVE CHANGES WILL GO IN THE DIRECTION OF TOUGHER RESTRAINING ACTION, NOT REFLATIONARY POLICIES. KEY QUESTION IS WILL EXPECTED MEASURES BE EFFECTIVE, BUT UNTIL SOME MEANINGFUL ABATEMENT IS SEEN IN RATE OF WAGE INCREASES AND INFLATION, GOVERNMENT'S POLICY IS ONE OF TACIT ACQUIESCENCE WITH GROWING UNEMPLOYMENT WHICH MAY WELL REACH 1.25 - 1.5 MILLION OR 5.5 - 6.6 PERCENT BY MID-1976. HIGHER END OF THAT RANGE WILL BE POLITICALLY UNACCEPTABLE AND THERE WILL BE PROGRESSIVE CALLS FROM LEFT

WING OF LABOR PARTY, UNIONS AND MOST SERIOUSLY AFFECTED INDUSTRIES FOR REFLATION AND RELIEF, INCLUDING SELECTIVE IMPORT CONTROLS. THE OPPOSITION CONSERVATIVE PARTY GIVES EVERY INDICATION THAT IT WILL SUPPORT TOUGH MEASURES TO CONTROL INFLATION, THE MAJOR COMPLAINT BEING THAT THE LABOR PARTY HAS BEEN TOO SLOW AND INEFFECTIVE UP TO NOW. HOWEVER, GOVERNMENT SHOWS EVERY INDICATION THAT FOR THE NEXT YEAR INFLATION IS PUBLIC ENEMY NUMBER ONE, AND THAT LIMITED OFFICIAL USE

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RELATIVE DEGREE TO WHICH IT WILL BE EXORCISED BY WAGE MODERATION OR BY RISING UNEMPLOYMENT DEPENDS ON THE UNIONS THEMSELVES.

5. RECALL THE CHANCELLOR'S STRATEGY: VIABLE LONG-TERM UK GROWTH CAN ONLY COME FROM EXPORT AND INVESTMENT-LED GROWTH IF STOP-GO POLICIES ARE TO BE AVOIDED. HIS TACTICS LOOKING AHEAD 12 MONTHS ARE TO REDUCE INFLATION; HOLD DOWN DOMESTIC DEMAND TO FREE RESOURCES FOR EXPORTS; AND AIDED BY A DECLINING EXCHANGE RATE, LINK THE UPTURN IN THE UK ECONOMY IN MID-1976 AND 1977 TO A FORESEEN UPTURN IN GROWTH IN WORLD TRADE IN 1976 AND 1977, STRENGTH OF WHICH AT LEAST IN ITS EARLY STAGES UK HAS OVERESTIMATED. IMMEDIATE DANGER TO TACTICS ARE COMPETITIVENESS OF UK EXPORT PRICES AND POTENTIAL SHORTAGES OF INDUSTRIAL CAPACITY. GOVERNMENT FULLY REALIZES IT CANNOT EXPAND DOMESTIC DEMAND CONSISTENT WITH EXPANDING EXPORTS OR BRINGING INFLATION UNDER CONTROL. THE NEXT 12 MONTHS LOOK ROUGH FOR THE AVERAGE ENGLISHMAN.

6. BUSINESSMEN REPORT LOW, BUT RISING CONFIDENCE ON OUTLOOK FOR EXPORT ORDERS, BUT BASED ON A HISTORY OF STOP-GO, IT IS UNLIKELY THAT THEY WILL INVEST TO EXPAND MANUFACTURING CAPACITY UNTIL THEY HAVE FULL ORDER BOOKS. RENEWED GOVERNMENT EFFORTS TO EXHORT INVESTMENT ARE IN THE OFFING; THEIR SUCCESS IS PROBLEMATIC. GIVEN LEAD TIME FOR INDUSTRIAL INVESTMENT THIS GIVES EXPECTATION OF BOTTLENECKS, SOME LOST EXPORT ORDERS, AND PROBABLY INCREASED IMPORTS FOR DOMESTIC MARKET BY 1977. AS GDP GROWTH RATES INCREASE, CAPACITY CONSTRAINTS MUST BE EXPECTED.

7. THE RESOUNDING SUCCESS OF THE EC REFERENDUM AND THE FILLIP IT HAS GIVEN TO HAROLD WILSON'S POLITICAL STRENGTH, AS WELL AS THE RENEWED COMMITMENT TO EC, MEANS THAT ARGUMENTS IN FAVOR OF SOLVING THE U.K.'S PROBLEMS THROUGH INWARD LOOKING RETREAT TO A SEIGE TYPE ECONOMY ARE DIMINISHED. THE U.K. MUST NOW PERSEVERE IN HOLDING DOWN DOMESTIC DEMAND. IF THE MEASURES THE PRIME MINISTER AND CHANCELLOR ARE EXPECTED TO INTRODUCE TO BRING DOWN IN-

FLATION AND DEAL WITH THE WAGE EXPLOSION ARE JUDGED TO BE
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EFFECTIVE - EFFECTIVE IS THE KEY WORD - THIS IN ITSELF
WILL HAVE A STEADYING EFFECT ON STERLING, AND COULD BE

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USED AS BASIS FOR AN EVENTUAL U.K. REQUEST TO EC, IMF
OR OECD FOR FINANCIAL SUPPORT AT COST BELOW WHAT PRIVATE
FINANCIAL MARKETS WOULD DEMAND.

8. SOME U.K. ECONOMIC POLICYMAKERS SEE THE INDUSTRIAL
WORLD ECONOMY GOING THROUGH A STRUCTURAL SHIFT, ENTERING
A DECADE WHEN GROWTH WILL BE SLOWER, UNEMPLOYMENT HIGHER,
AND ENERGY MORE EXPENSIVE. POLICY PROBLEMS WILL INCLUDE
HOW TO BALANCE HIGHER INFLATION WITH FULLEST POSSIBLE
UTILIZATION OF DOMESTIC ECONOMIC CAPACITY. SENIOR

ECONOMIC OFFICIALS REPORT THEY ARE UNAWARE OF ANY ESTIMATES OF EFFECT OF 1 PERCENT GROWTH IN U.S. ON DOMESTIC ACTIVITY, BUT ADD IT SHOULD NOT BE IMPOSSIBLE TO WORK IT OUT AS A RESIDUAL IN A COMPUTER EXERCISE. IN CRUDE MODEL' FIRST STEP WOULD BE TO ESTIMATE EFFECT OF 1 (OR X) PERCENT GROWTH REAL U.S. GNP ON COMPOSITION OF U.S. IMPORTS, THEN EXAMINE U.K. SHARE OF VARIOUS U.S. IMPORT CATEGORIES, MAKING ASSUMPTIONS ABOUT U.K. ABILITY TO HOLD MARKET SHARES, THEN MAKE ASSUMPTIONS ABOUT EFFECTS OF THESE INCREASED U.K. EXPORTS TO U.S. ON U.K. DOMESTIC ACTIVITY. AS NOTED, INITIAL CONVERSATIONS WERE NEGATIVE, LIMITED OFFICIAL USE

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DID NOT YIELD ANY IDEAS OF WHAT THESE EFFECTS MIGHT BE. I HAVE ASKED BRITT SWOFFORD TO INQUIRE FURTHER ON THIS POINT ELSEWHERE IN H.M.TREASURY.

9. AS NOTED ABOVE, EXPORT LED GROWTH IS THE FUNDAMENTAL ASPECT OF U.K. HOPES OF DOMESTIC RECOVERY IF U.K. IS TO BREAK THE STOP-GO CYCLE. COMBINATION OF (A) CONSERVATIVE CHANCELLOR BARBER'S DOMESTIC CONSUMER LED GROWTH POLICY IN 1971-1972 WHICH HAD DISASTROUS EFFECTS ON EXTERNAL ACCOUNTS, AND (B) PUBLIC EXPENDITURE INCREASES OF LABOR GOVERNMENT HAVE FUELED INFLATION AND MISDIRECTED RESOURCES THAT COULD HAVE OTHERWISE BEEN AVAILABLE FOR EXPORT, OR IMPORT SUBSTITUTES. ONE REFLECTION OF THESE POLICIES HAS BEEN CONTINUING FALL IN POUND SINCE JUNE 1972.

10. MY OWN GUESSES FOR RANGES OF PERCENTAGE GROWTH OF GDP, PRICES AND UNEMPLOYMENT WOULD BE AS FOLLOWS' YEAR-ON-YEAR, BEARING IN MIND THAT 1975 GDP GROWTH DISTORTED BY VERY POOR SHOWING IN FIRST QUARTER 1974. WITH SAY ZERO TO MINUS POINT FIVE (0 TO -0.5) FROM FOURTH QUARTER OF 1974 TO FOURTH QUARTER OF 1975:

	1975	1976	1977
GDP	0.5-1.0	1.5-2.0	2.4-2.9
RETAIL PRICE INDEX (PERCENT)	25-28	18-21	10-13
UNEMPLOYMENT (HIGHEST LEVEL)	4.4-4.6	5.5-6.6	4.0-4.5

ABOVE PRESUPPOSES UPTURN IN WORLD TRADE BEGINNING LATER THIS YEAR AND NEXT, NEW GOVERNMENT MEASURES TO CUT PUBLIC EXPENDITURE, INCREASING MODERATION IN UNION WAGE DEMANDS IN FACE OF RISING UNEMPLOYMENT, AND QUARTERLY FALL IN WEIGHTED EXCHANGE RATE THROUGH END-1976 IN RANGE OF 1.5 TO 2.5 PERCENT. PROJECTED UNEMPLOYMENT BY END 1975 EXPECTED TO BE SLIGHTLY OVER A MILLION, RISING TO 1.25 TO 1.5 MILLION IN 1976, THE OUTER LIMIT OF WHAT IS CONSIDERED POLITICALLY POSSIBLE. THEN FALLING ONLY SLOWLY INTO 1977 AS RESULT OF LABOR SHAKEOUT, IN PART RELUCTANCE OF EMPLOYERS TO TAKE BACK SURPLUS LABOR, WITH SOME OF

1977 GROWTH DUE TO INCREASED PRODUCTIVITY AS RESULT OF
MORE EFFECTIVE USE OF LABOR, INCREASED LABOR MOBILITY,
AND WAGE MODERATION RESULTING FROM FORTHCOMING VERY
ROUGH TWELVE-EIGHTEEN MONTH PERIOD THAT LABOR FORCE WILL
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GO THROUGH.

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11. CHANCELLOR HOPES TO HALVE CURRENT RATE OF PRICE
INFLATION (TO ABOUT 12 PERCENT) OVER NEXT TWELVE MONTHS.
MY PRICE GUESSES GIVE HIM BENEFIT OF DOUBT ON THIS, BUT
ANTICIPATE IT WILL TAKE 50 PERCENT LONGER THAN EXPECTED.
THE DISCOURAGING ELEMENT IS THAT IF SIGNIFICANT WORLD UP-
TURN DOES TAKE PLACE IN 1976-1977, U.K. WILL BE
ENTERING UPSWING IN CYCLE WITH ALREADY EXISTING DOUBLE

DIGIT INFLATION. NOTE THAT MY FORECAST FOR PRICES IN 1977 IS MORE OPTIMISTIC THAN LONDON BUSINESS SCHOOL (PARA 13 FOLLOWING). BUT I SEE UNEMPLOYMENT GOING UP MORE SHARPLY IN 1976.

12. ASIDE FROM LONDON BUSINESS SCHOOL, THERE ARE NO AVAILABLE MEDIUM-TERM PROJECTS (I.E. BEYOND 1976) EXCEPT FOR ECONOMETRIC SERVICES TOO EXPENSIVE FOR ME TO SUBSCRIBE TO (THEY DON'T GIVE AWAY FREE COPIES). I DISCUSSED MY ABOVE ESTIMATES INFORMALLY WITH SENIOR H.M. TREASURY OFFICERS LAST WEEK. OFF THE RECORD, THEY HAVE NO QUARREL WITH MY ESTIMATES OF ZERO GROWTH THIS YEAR AND 25 PERCENT INCREASES IN PRICES. OFFICIAL PUBLIC LIMITED OFFICIAL USE

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ESTIMATES PUT UNEMPLOYMENT AT ONE MILLION BY YEAR'S END. THESE OFFICIALS THOUGHT ME TOO PESSIMISTIC ON NEXT YEAR; THEY SEE DISCERNABLE GNP GROWTH, POSSIBLY AS HIGH AS 3 PERCENT AND TAKE PARTY LINE THAT ANNUAL RATE OF CONSUMER PRICE INCREASE CAN, ON OPTIMISTIC ASSUMPTIONS, BE REDUCED TO 12 PERCENT BY MIDDLE OF NEXT YEAR. SUBJECTIVELY, I HOPE THEY ARE RIGHT; OBJECTIVELY, I DON'T THINK THEY ARE. ON UNEMPLOYMENT IN 1976, THEY SEE 1.25 MILLION (5.5 PERCENT) AS SOMETHING THAT COULD HAPPEN, ALTHOUGH AGAIN THEY SEE IT AS TOO PESSIMISTIC AND CONSIDER 1.5 MILLION (6.6 PERCENT) AS BEING POLITICALLY UNACCEPTABLE. BANK OF ENGLAND TAKES MORE PESSIMISTIC VIEW THAN TREASURY. H.M. TREASURY SOURCES CLAIM IT IMPOSSIBLE TO MAKE MEANINGFUL PROJECTIONS FOR 1977 IN ABSENCE OF KNOWLEDGE OF ACTUAL WORLD TRADE TRENDS AND TRADE UNION RESPONSE TO GOVERNMENT REQUEST FOR WAGE RESTRAINT.

13. ON OTHER MEDIUM-TERM FORECASTS, YOU ALREADY HAVE TEXT OF LONDON BUSINESS SCHOOL'S (LBS) LATEST (A-432) AND SUMMARY OF NIESR'S LATEST (LONDON 9006). RECALL:

	1975	1976	1977
GDP			
LBS		0.9	1.6 3.2
NIESR		1.6	2.6 N.A.
CONSUMER PRICES			
LBS	24.3	22.7	17.3
NIESR	20.7	17.5	N.A.

MAJOR DIFFERENCE IN ASSUMPTIONS IS THAT LBS IS ON BASIS OF 10 PERCENT STERLING DEPRECIATION IN 1975 FOLLOWED BY ABOUT 1.5 PER QUARTER IN 1976. NIESR'S FORECAST MADE IN EARLY MAY ASSUMED EFFECTIVE DEVALUATION OF 26 PERCENT BELOW SMITHSONIAN BY END OF THIS YEAR (RATE SANK TO 26 PERCENT IN EARLY JUNE), CONTINUING TO FALL BY 2 PERCENT PER QUARTER IN 1976. LBS SEES UNEMPLOYMENT RISING TO PEAK OF 1.2 MILLION IN SECOND QUARTER OF 1977. NIESR

SEES UNEMPLOYMENT OF ABOUT 1.1 MILLION THIS WINTER
(ABOUT 5 PERCENT). NOTE THAT THERE IS DIFFERENCE IN
TERMINOLOGY BETWEEN CONSUMER PRICES AND RETAIL PRICE
INDEX. NIESR ESTIMATES RETAIL PRICE INDEX ABOUT 2 - 3
PERCENTAGE POINTS ABOVE CONSUMER PRICE INDEX.

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14. THANKS FOR THE CHANCE TO COMMENT; HOPE YOU FIND
ABOVE PERSONAL JUDGMENTS AND VIEWS OF SOME VALUE.

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